

**Statement for the Record of Dr. Dov S. Zakheim  
Under Secretary of Defense (Comptroller)  
House Committee on Government Reform  
11 March 2004**

Mr. Chairman, members of the committee, my statement for this hearing will focus on Department of Defense (DoD) oversight of contracts related to military operations and reconstruction in Iraq.

**DoD Contract Performance Oversight Responsibilities**

The Department of Defense considers the oversight of contracts an essential responsibility. We have a number of strong organizations, policies, and regulations to fulfill this responsibility. DoD's task is not only to identify contract issues, but also to prevent future occurrences of problems we identify, recover any excess charges, and take appropriate action against any contractor wrongdoing.

As the Under Secretary of Defense (Comptroller) and the Department's Chief Financial Officer, I am responsible for ensuring adequate financial management of funds spent on the reconstruction of Iraq. My involvement in DoD contract performance oversight comes primarily from my office's responsibility for the Defense Contract Audit Agency (DCAA). DCAA's mission is to provide all contract audit and financial advisory services related to DoD acquisition of goods and services. Other DoD organizations not within my office -- such as the Defense Contract Management Agency (DCMA) and DoD Inspector General (DoDIG) -- also play important contract oversight roles and work closely with DCAA. The Under Secretary of Defense (Acquisition, Technology and Logistics) is responsible for the contract policies that help ensure the Department obtains the best value when acquiring equipment and services and is also responsible for DCMA.

The Army and DCAA are strategic partners in the oversight of contractor performance. The Army, as the executive agent for all Department reconstruction requirements in Iraq, is responsible for contract and program management activities there. DCAA, which is collocated with Army personnel in Baghdad, evaluates all contractor proposals and reviews all billing paperwork for primes and subs.

My office's financial management activities in Iraq began at the end of major combat operations there. I created and had in place by late April 2003 a 20-member forward cell that included representatives from the DCAA, DoDIG, Office of Management and Budget (OMB), DCMA, Joint Staff, U.S. Agency for International Development (USAID), and General Accounting Office (GAO). This team and its supporting rear cell at the Pentagon were especially critical to getting the Coalition Provisional Authority fully operational and capable of undertaking its enormously complex reconstruction tasks.

DoD contract performance oversight is now being supported by DCAA's Iraq Branch Office under Branch Manager Dan Altemus. The Office now has 25 auditors, and will increase to 31 auditors by the end of May. Complementing this in-country support, DCAA has auditors that

also provide contract oversight of U.S. firms at stateside locations that have major contracts in Iraq.

### **Summary of Findings and Actions**

DoD oversight of contract performance in Iraq has uncovered a number of problems. Our resulting action has ranged from recommending changes in processes, to rejection of unsupported proposal costs, to reductions in billed costs for potentially unreasonable expenditures, to referral of our findings to the DoD Inspector General for possible legal action against a contractor.

Contractor performance in Iraq has been neither perfect, nor terrible. Iraq presents a difficult security environment for contractors. Many contractors that have not had problems in performing their domestic DoD contracts are having difficulties in adjusting to the unique environment in Iraq and to their own firms' influx of new business. We believe that contractor financial and internal control problems will resolve themselves, but in the meantime, we will take whatever actions are necessary to protect the Government's financial interests. DoD has enforced and will continue to enforce the highest standards for contracts in Iraq and anywhere else.

Halliburton, mainly through its Kellogg, Brown and Root (KBR) subsidiary, is the largest contractor operating in Iraq – with contract ceilings approaching \$18 billion. We are not surprised that the largest contractor has the bulk of the contract problems we have found. KBR has been responsive to reported contract findings and has agreed to work on improving its contract performance.

Contract problems reported to date generally have been caused by contractor deficiencies, not by problems with contract policies or the DoD organizations managing these contracts. Still, to mitigate this latter possibility, the Department has taken action to ensure that its contract processes are integrated, effective, and efficient. Especially significant has been creation of the CPA's Program Management Office and Inspector General.

I will now provide details on DoD oversight of Iraq contracts and the major issues we have identified.

### **DCAA Staffing and Actions**

Since April 2003, DCAA has worked with all Iraq-based U.S. procurement organizations to determine the need for audit support. These organizations include the CPA, Army Materiel Command, Army Corps of Engineers, USAID, and State Department. This coordination has enabled DCAA to build a universe of all Iraq-related auditable contracts, which is a significant step towards ensuring that needed audit procedures are comprehensive, and performed effectively and efficiently. DCAA has established a contract audit universe (for cost-type incurred cost, internal control, and contract payment audits) that presently includes more than 60 prime contracts with contract ceiling amounts of \$24.9 billion and funding/awards to-date under those contracts of about \$9.7 billion.

DCAA's services include professional advice to customers in Iraq – most notably the U.S. Army and USAID -- on accounting and financial matters to assist them in the negotiation, award, administration, repricing, and settlement of contracts. Especially important has been DCAA's in-country testing of contractor timekeeping, subcontract management, and cash disbursement procedures. DCAA's real-time audits are critical to ensuring that contractor internal control systems are adequate and costs are properly charged to Government contracts.

During FY 2004 DCAA has already issued over 180 audit reports related to contractors involved in Iraq reconstruction. These reports address forward pricing proposals, costs directly incurred on existing contracts, and contractor policies and internal controls.

### **Contract Issues for Halliburton – KBR**

KBR has been awarded Iraq Reconstruction contracts with ceilings totaling \$17.6 billion under two major programs: \$9.4 billion under the Logistics Civil Augmentation Program (LOGCAP III) contract; and \$8.2 billion under the Restore Iraqi Oil (RIO) contract. DCAA has been providing continuous contract audit oversight on both programs.

The U.S. Army Materiel Command competitively awarded the LOGCAP III contract to the company now known as KBR on December 14, 2001. Today, under LOGCAP III, KBR supports U.S. operations in Afghanistan, Kuwait, Djibouti, Republic of Georgia, Uzbekistan, and Iraq.

Estimating practices. DCAA has identified significant deficiencies in KBR's estimating practices related to the award of subcontract costs. Earlier this year after consultation with the contracting officer, DCAA returned two major task order proposals (worth more than \$3 billion) to KBR because they were inadequate for the purposes of negotiating a fair and reasonable price. KBR later resubmitted one of the task orders for \$700 million less than the original proposal. Even this resubmitted proposal was later withdrawn by KBR due to continuing pricing issues. These issues included proposal subcontract costs that were significantly different from previously negotiated actual subcontract amounts and the use of proposal estimates instead of more than \$290 million of actual costs already incurred – both disclosed during the DCAA audit.

On January 13, 2004, DCAA notified the appropriate Government contracting officials that KBR's subcontracting estimating process and procedures were considered inadequate and recommended that DCAA be advised before the negotiation of any future contract awards.

KBR's deficiencies in estimating subcontracts were the catalyst for DCAA's review of potential gasoline overpricing under the Restore Iraqi Oil contract. The review found significant issues related to KBR's pricing and award of subcontract costs. It disclosed potential overpricing on gasoline of \$61 million through September of 2003. During DCAA's review, the auditors came across other information that led them to make a referral to the DoD Inspector General, which recently launched an investigation of this potential overpricing of gasoline.

Dining Facility Subcontract Costs. DCAA has identified inadequate support for billed dining facility costs. In DCAA's opinion the billed number of meals appears to exceed significantly the actual meals served. DCAA and KBR have agreed on a withholding of \$176.5 million (\$140.7 million that KBR voluntarily withheld from future billings and

\$35.8 million that DCAA suspended on current billings), while KBR prepares a response to issues reported by DCAA.

Violation of the Anti-Kickback Act. KBR has voluntarily disclosed a possible violation of the Anti-Kickback Act by two of its employees. KBR has already reimbursed the Government for the estimated impact of \$6.3 million. DCAA has requested supporting data from KBR to validate the \$6.3 million.

Application of Federal Acquisition Regulations (FAR). DCAA has helped identify contracting issues that stem from the fact that major contracts in Iraq have been slow to get definitized, that is to get a definite contract price negotiated. The FAR allows the government to award a letter contract when there is insufficient time to negotiate a well-defined contract with a specified price – insufficient time because of pressing requirements that contract would meet. However, in those situations it is important to negotiate prices as soon as practical after award to avoid negotiating a price after most or all the costs have been incurred by the contractor. The use of letter contracts in Iraq stems from the rapidly changing situation there, which often causes changes in contract requirements – for example, for services and equipment. Federal Acquisition Regulations limit contract reimbursement to a maximum of 85 percent of allowable costs until a contract is definitized.

DCAA found that KBR was not observing this 85 percent limit in the reimbursement vouchers it submitted for its undefinitized LOGCAP task orders. In late February DCAA told KBR that it should apply the 85 percent limit to its vouchers. The Army's contracting officer has received KBR's response to the DCAA recommendation and is evaluating it. If the required 15 percent withhold is applied to all costs billed under undefinitized LOGCAP task orders, the total withhold would be about \$200 million. After these task orders are definitized, this withheld amount would be available for reimbursement if otherwise allowable per DCAA audit.

### **Other Contract Issues**

Titan Corporation. In 1999, Titan was awarded an Indefinite Delivery/Indefinite Quantity contract with a current ceiling amount of \$294 million to provide linguist and translator services to the U.S. Government. The majority of the current contract costs center on Iraq support. Recent DCAA audits disclosed deficiencies in Titan's labor distribution system, which records costs for Titan employees. DCAA also found that Titan lacked procedures for adequate tracking of hours worked by foreign national consultants. Based on these findings, the DCMA contracting officer implemented a 10 percent withhold on all of Titan's labor and consultant costs until all identified deficiencies are corrected and bills to the Government are based on adequate internal controls. The resulting withhold amount could be as much as \$4.9 million on future billings depending on the timeliness of the needed improvements.

Restore Iraq Electricity (RIE). In January and February of 2004, DCAA auditors evaluated proposal costs exceeding \$900 million from the three prime contractors for the REI program: Fluor Federal Systems, Perini Corporation, and Washington Group International. As a result of these proposal reviews, DCAA reported to the Army Corps of Engineers that all three contractors had substantial subcontract pricing issues. Examples included an absence of any

documentation for selection of a specific subcontractor, and the absence of cost and pricing data to establish fair and reasonable prices.

DCAA will continue to perform oversight of the subcontract estimating and billed costs. DCAA will work closely with the prime contractors and the Army Corps of Engineers to ensure that future subcontract estimates are adequate. In addition, DCAA will evaluate each voucher submitted by the prime contractors to ensure that contract costs (including subcontract costs) are properly billed and paid.

### **Closing**

In closing, I want to underscore that we in the Department of Defense are absolutely committed to an integrated, well-managed contracting process in Iraq. We will not tolerate the billing of costs that are not properly documented and supported. If internal control systems are deficient, we will continue to use protections, such as contract withholdings, to safeguard our interests. And we will provide whatever personnel and budget resources are needed to enforce integrity in DoD contracts.

My Comptroller organization will continue to work with other organizations within and outside the Department to assist those organizations and share our findings. From the beginning, DCAA and my office have coordinated closely with the GAO and DoDIG, and with the CPA IG once it was created. We have regularly provided these organizations with information on our activities. This included detailed briefings by DCAA to the GAO on June 23 and November 7, 2003. This past January 7, DCAA Director Bill Reed and I personally briefed Comptroller General David Walker and the Deputy DoD Inspector General Gene Reardon on DCAA's contract audit support of Iraq reconstruction. DCAA and my office are the primary source of information on Iraq contract oversight for the GAO and DoDIG. They have been supportive of our work in Iraq and allowed DCAA to continue its programmed audits without attempting to duplicate their work.

In sum I believe that the Department's contract oversight has been vigilant, and we will ensure that it continues. I look forward to addressing whatever questions or comments you have on this oversight. Thank you.